Before the
Administrative Hearing Commission
State of Missouri

AT&T COMMUNICATIONS OF THE SOUTHWEST, INC.,)
Petitioner,)
vs.) No. 11-1375 RI
DIRECTOR OF REVENUE,)
Respondent.)

DECISION

AT&T Communications of the Southwest, Inc. ("AT&T SW") is entitled to a refund of $86,511 in corporate income tax plus statutory interest for the 2003 tax year. AT&T SW is liable for an additional $307,204 in corporate income tax plus statutory interest for the 2004 tax year; and it is liable for an additional $210,258 in corporate income tax plus statutory interest for the 2005 tax year.

Procedure

AT&T SW filed a complaint on July 1, 2011, appealing three final decisions issued by the Director of Revenue ("Director") for tax years 2003, 2004, and 2005.

This Commission convened a hearing on the complaint on August 9, 2012. Mark A. Olthoff and William B. Prugh of Polsinelli Shughart, P.C., represented AT&T SW. Wood Miller, Managing Counsel, and Michael Murray represented the Director. The matter became ready for our decision on December 6, 2012, when AT&T SW filed its final written argument.

Commissioner Sreenivasa Rao Dandamudi, having read the full record including all the evidence, renders the decision.[1]

Issues

1. Whether the facts support that AT&T SW's passive interest income, received from its parent company, is non-Missouri source income. This issue is applicable to all tax years.

2. Whether allocation of passive, non-Missouri source interest income received from a parent company is available when calculating corporate income tax under § 143.451.6. This issue is applicable to all tax years.

3. Whether passive, non-Missouri source interest income may be included under modifications subtractions when calculating corporate income tax under § 143.451.6. This issue is applicable to the 2003 tax year.

In both our findings of fact and conclusions of law, we analyze these tax years in the following order: 2004, 2005, 2003. Due to the nature in which AT&T SW subtracted its passive interest income as a modification in 2003, this order makes it easier to understand the way in which we calculated tax in the findings of fact and the natural flow of legal reasoning in our conclusions of law.

Findings of Fact

<u>Background</u>

1. AT&T SW was incorporated in Delaware and was domiciled in New Jersey at all relevant times. AT&T SW provided intrastate long-distance telephone service in Missouri and four other states at all relevant times.

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[1]Section 536.080.2; ***Angelos v. State Bd. of Regis'n for the Healing Arts***, 90 S.W.3d 189 (Mo. App. S.D. 2002). Statutory references are to RSMo 2000, unless otherwise noted.

2. AT&T SW was a wholly owned subsidiary of AT&T Corporation ("AT&T") at all relevant times. AT&T was a Delaware corporation domiciled in New Jersey at all relevant times.

3. On September 30, 2001, AT&T SW and AT&T entered into a note. This note was negotiated and signed outside Missouri and governed by the laws of New York.

4. According to the terms of the note, all of AT&T SW's customer payments went directly to AT&T's bank account, which is located outside Missouri. This bank account was used to pay AT&T SW's expenses.

5. Also according to the terms of the note, excess cash over AT&T SW's expenses was loaned to AT&T in return for monthly interest payments.

6. AT&T made all decisions as to how to use or invest the money loaned to it by AT&T SW outside Missouri. AT&T SW had no input on the use or investment of the loaned money. The monthly interest payments to AT&T SW were passive interest income.[2] AT&T SW received these monthly interest payments outside Missouri.

7. All AT&T employees involved with the management of the loans from this note were located outside Missouri.

<u>2004 Tax Year</u>

8. The 2004 tax year consisted of the entire calendar year.

9. On its 2004 tax return, AT&T SW used the wire mileage method of apportionment under § 143.451.6 to determine how much of its total interstate income should be apportioned to Missouri. AT&T SW allocated its passive interest income as nonbusiness income outside Missouri.

[2] The fact that this was passive interest income is not in dispute.

10. AT&T SW determined its Missouri corporate income tax liability for the 2004 tax year by the following method:

First, because it allocated nonbusiness income, AT&T SW calculated its Missouri income percentage:

	$239,047,011	(total federal taxable income)
-	$ 3,866,582	(Missouri modifications subtractions)[3]
	$235,180,429	(Missouri taxable income – all sources)
-	***$168,265,338***	***(nonbusiness income – all sources)***[4]
	$ 66,915,091	(total apportionable interstate income)
x	0.13198	(wire mileage method percentage) [5]
	$ 8,831,454	(interstate income apportioned to Missouri)
+	$ 6,254,607	(nonbusiness income allocated to Missouri)[6]
	$ 15,086,061	(partial Missouri taxable income)
÷	$239,047,011	(total federal taxable income)
	0.06415	(Missouri income percentage)

Second, AT&T SW calculated its corporate income tax liability:

	$235,180,429	(Missouri taxable income – all sources)
x	0.06415	(Missouri income percentage)
	$ 15,086,825	(Missouri taxable income)
x	0.0625	(Missouri corporate income tax rate)
	$ 942,927	(Missouri corporate income tax liability)

11. On October 1, 2008, the Director began a combined field audit for the 2004 and 2005 tax years. This field audit resulted in the following changes to the determination of AT&T SW's corporate income tax liability for the tax year 2004:

A. Lowering the wire mileage percentage to 0.12242; and

B. Eliminating all allocated nonbusiness income and expenses, including passive interest income, so all income was apportioned. Rather than calculate a Missouri income percentage, the Director

[3] Missouri depreciation basis adjustment.

[4] This amount is all gross nonbusiness income from everywhere ($788,992,620) less all nonbusiness related expenses from everywhere ($620,727,282). Gross nonbusiness income from everywhere is the sum of interest income received from the loan to AT&T ($120,206,047) and income related to intrastate telecom activities everywhere ($668,786,573).

[5] The wire mileage method, used by telephone companies, requires the total telephonic and telegraphic investments of a company in Missouri by December 31 to be divided by that company's total telephonic and telegraphic investments everywhere. This percentage is used to determine the portion of its total interstate income that is taxable in Missouri under § 143.451.6. This percentage varies each year.

[6] This amount is gross nonbusiness income from Missouri less nonbusiness related expenses from Missouri.

used a straight corporate income tax calculation similar to the 2003 tax year.

12. Based on the field audit changes, the Director calculated AT&T SW's corporate income tax liability for the 2004 tax year as:

	$235,180,429	(Missouri taxable income – all sources)
x	0.12242	(revised wire mileage method percentage)
	$ 28,790,788	(revised Missouri taxable income)
x	0.0625	(Missouri corporate income tax rate)
	$ 1,799,424	(revised Missouri corporate income tax liability)

13. Under the Director's calculation, AT&T SW owes an additional $856,497 plus interest for the 2004 tax year.

14. On March 1, 2010, based on the field audit's revised Missouri corporate income tax liability, the Director issued a notice of deficiency for the difference in corporate income tax plus statutory interest. The actual amount of this notice of deficiency contains a change in franchise tax and previously paid refunds. So the amount on the deficiency is not the amount actually in dispute.

15. On April 7, 2010, AT&T SW protested the Director's notice of deficiency ***solely*** for the elimination of passive interest income from allocated nonbusiness income. AT&T SW did not protest the new, lower wire mileage percentage produced by the field audit, and it did not protest the apportionment of previously allocated intrastate telecom activities. Because we find passive interest income from AT&T should be allocated outside Missouri, we must determine the new and final corporate income tax liability for tax year 2004 by using the lower wire mileage percentage and lower allocated nonbusiness income:

First, we calculate the Missouri income percentage:

	$239,047,011	(total federal taxable income)
-	$ 3,866,583	(Missouri modifications subtractions)
	$235,180,429	(Missouri taxable income – all sources)
-	***$120,206,047***	***(nonbusiness income – passive interest income)***

$ 114,974,382	(total apportionable interstate income)
x 0.12242	(revised wire mileage method percentage)
$ 14,075,164	(revised interstate income apportioned to Missouri)
+ $ 6,254,607	(nonbusiness income allocated to Missouri)[7]
$ 20,329,771	(revised partial Missouri taxable income)
÷ $239,047,011	(total federal taxable income)
0.08505	(Missouri income percentage)

Second, we calculate the corporate income tax liability:

$235,180,429	(Missouri taxable income – all sources)
x 0.08505	(revised Missouri income percentage)
$ 20,002,096	(revised Missouri taxable income)
x 0.0625	(Missouri corporate income tax rate)
$ 1,250,131	(final Missouri corporate income tax liability)

16. By allocating passive interest income outside Missouri, apportioning intrastate telecom services, and using the Director's revised, lower wire mileage percentage, AT&T SW's final corporate income tax liability for the 2004 tax year is $1,250,131. While we find in favor of AT&T SW, that passive interest income it received from AT&T is allocated nonbusiness income, its corporate income tax liability for the 2004 tax year still increases by $307,204 over what it filed on its 2004 tax return due to the differences in the wire mileage percentage and greater apportioned income.

<u>2005 Tax Year</u>

17. The 2005 tax year consisted of January 1, 2005 through November 18, 2005.

18. On its 2005 tax return, AT&T SW used the wire mileage method of apportionment under § 143.451.6 to determine how much of its total interstate income should be apportioned to Missouri. Like 2004, AT&T SW allocated its passive interest income as nonbusiness income outside Missouri.

19. AT&T SW determined its Missouri corporate income tax liability for the 2005 tax year by the following method:

[7] This amount is gross nonbusiness income from Missouri less nonbusiness related expenses from Missouri.

First, AT&T SW calculated its Missouri income percentage:

	$237,816,866	(total federal taxable income)
-	$ 2,046,640	(Missouri modifications subtractions)[8]
	$235,770,226	(partial Missouri taxable income – all sources)
-	***$196,568,660***	***(nonbusiness income – all sources)***[9]
	$ 39,201,566	(total apportionable interstate income)
x	0.11741	(wire mileage method percentage)
	$ 4,602,656	(interstate income apportioned to Missouri)
+	$ 3,961,639	(nonbusiness income allocated to Missouri)[10]
	$ 8,564,295	(partial Missouri taxable income)
÷	$235,770,226	(partial Missouri taxable income – all sources)
	0.03632	(Missouri income percentage)[11]

Second, AT&T SW calculated its corporate income tax liability:

	$235,770,226	(partial Missouri taxable income – all sources)
-	$ 10,142,557	(federal income tax)
	$225,627,669	(Missouri taxable income – all sources)
x	0.03632	(Missouri income percentage)
	$ 8,194,797	(Missouri taxable income)
x	0.0625	(Missouri corporate income tax rate)
	$ 512,175	(Missouri corporate income tax liability)

20. The result of the combined field audit for the 2004 and 2005 tax years resulted in the following changes to the determination of AT&T SW's corporate income tax liability for the tax year 2005:

A. Eliminating all allocated nonbusiness income and expenses, including passive interest income, so all income was apportioned. Rather than calculate a Missouri income percentage, the Director used a straight corporate income tax calculation similar to the 2003 tax year; and

B. using a revised federal income tax.

[8] Missouri depreciation basis adjustment.

[9] This amount is all gross nonbusiness income from everywhere ($651,108,147) less all nonbusiness related expenses from everywhere ($454,539,487). Gross nonbusiness income from everywhere is the sum of interest income received from the loan to AT&T ($166,631,661) and income related to intrastate telecom activities everywhere ($484,476,486).

[10] This amount is gross nonbusiness income from Missouri less nonbusiness related expenses from Missouri.

[11] This figure is rounded.

21. Based on the field audit change, the Director calculated AT&T SW's corporate income tax liability for the 2005 tax year as:

	$235,770,226	(partial Missouri taxable income – all sources)
-	$ 10,142,314	(revised federal income tax)
	$225,627,912	(revised Missouri taxable income – all sources)
x	0.11741	(wire mileage method percentage)
	$ 26,490,973	(revised Missouri taxable income)
x	0.0625	(Missouri corporate income tax rate)
	$ 1,655,686	(revised Missouri corporate income tax liability)

22. Under the Director's calculation, AT&T SW owes an additional $1,143,511 plus interest for the 2005 tax year.

23. On March 1, 2010, based on the field audit's revised Missouri corporate income tax liability, the Director issued a notice of deficiency for the difference in corporate income tax plus statutory interest. The actual amount of this notice of deficiency contains a change in franchise tax and previously paid refunds. So the amount on the deficiency is not the amount actually in dispute.

24. On April 7, 2010, AT&T SW protested the Director's notice of deficiency for the elimination of passive interest income from allocated nonbusiness income. AT&T SW did not protest the apportionment of previously allocated intrastate telecom activities, and it did not protest the use of a revised federal income tax. Because we find passive interest income from AT&T should be allocated outside Missouri, we must determine the new and final corporate income tax liability for tax year 2005 by using the revised federal income tax and lower allocated nonbusiness income.

First, we calculate the Missouri income percentage:

First, AT&T SW calculated its Missouri income percentage:

	$237,816,866	(total federal taxable income)
-	$ 2,046,640	(Missouri modifications subtractions)
	$235,770,226	(partial Missouri taxable income – all sources)

-	***$166,631,661***	***(nonbusiness income – passive interest income)***
	$ 69,138,565	(total apportionable interstate income)
x	0.11741	(wire mileage method percentage)
	$ 8,117,559	(interstate income apportioned to Missouri)
+	$ 3,961,639	(nonbusiness income allocated to Missouri)[12]
	$ 12,079,198	(partial Missouri taxable income)
÷	$235,770,226	(partial Missouri taxable income – all sources)
	0.05123	(Missouri income percentage)[13]

Second, we calculate its corporate income tax liability:

	$235,770,226	(partial Missouri taxable income – all sources)
-	$ 10,142,314	(revised federal income tax)
	$225,627,912	(Missouri taxable income – all sources)
x	0.05123	(Missouri income percentage)
	$ 11,558,918	(Missouri taxable income)
x	0.0625	(Missouri corporate income tax rate)
	$ 722,433	(Missouri corporate income tax liability)

25. By allocating passive interest income outside Missouri, apportioning intrastate telecom services, and using the revised federal income tax, AT&T SW's final corporate income tax liability for the 2005 tax year is $722,433. While we find in favor of AT&T SW, that passive interest income it received from AT&T is allocated nonbusiness income, its corporate income tax liability for the 2005 tax year still increases by $210,258 over what it filed on its 2005 tax return due to the differences in federal income tax and greater apportioned income.

2003 Tax Year

26. The 2003 tax year consisted of the entire calendar year.

27. On its 2003 tax return, AT&T SW used the wire mileage method of apportionment under § 143.451.6 to determine how much of its total interstate income should be apportioned to Missouri. During its corporate income tax calculation, it subtracted the passive interest income it received from AT&T as a modification, when it should have allocated such income as nonbusiness income not from a Missouri source.

[12] This amount is gross nonbusiness income from Missouri less nonbusiness related expenses from Missouri.

[13] This figure is rounded.

28. AT&T SW calculated its Missouri corporate income tax liability for the 2003 tax year by the following method:

	$401,016,705	(total federal taxable income)
+	$ 19,714,836	(state income tax deducted to determine federal income tax)
	$420,731,541	
-	***$148,624,983***	***(Missouri modifications subtractions)***[14]
	$272,106,558	
-	$ 5,605,789	(federal income tax)
	$266,500,769	(Missouri taxable income – all sources)
x	0.09608	(wire mileage method percentage)
	$ 25,605,394	(Missouri taxable income)
x	0.0625	(Missouri corporate income tax rate)
	$ 1,600,337	(Missouri corporate income tax liability)

29. On October 18, 2005, the Director began a field audit for the 2003 tax year. This field audit resulted in eliminating $148,555,163 from Missouri modifications subtractions. This was the amount of passive interest income received from AT&T during this tax year. The Director's calculation of AT&T SW's 2003 tax liability resulted in the following:

	$266,500,769	(Missouri taxable income – all sources)
+	$148,555,163	(Missouri modifications adjustment)
	$415,055,932	(revised Missouri taxable income – all sources)
x	0.09608	(wire mileage method percentage)
	$ 39,878,574	(revised Missouri taxable income)
x	0.0625	(Missouri corporate income tax rate)
	$ 2,492,411	(revised Missouri corporate income tax liability)

30. Under the Director's calculation, AT&T SW owes an additional $892,074 in corporate income tax for the 2003 tax year.

31. On November 6, 2009, based on the field audit's revised Missouri corporate income tax liability, the Director issued a notice of deficiency for the difference in corporate income tax plus statutory interest. The actual amount of this notice of deficiency contains a change in

[14] Missouri modifications subtractions is the sum of passive interest income received from the loan to AT&T ($148,555,163) and depreciation ($69,820).

franchise tax and previously paid refunds. So the amount on the deficiency is not the amount actually in dispute.

32. On January 4, 2010, AT&T SW protested the Director's notice of deficiency for the elimination of passive interest income from its Missouri modifications subtractions. Because we find passive interest income from AT&T should be allocated outside Missouri, we must determine the new and final corporate income tax liability for tax year 2003 by allocating it as nonbusiness income:

First, we calculate the Missouri income percentage:

	$401,016,705	(total federal taxable income)
-	$ 69,820	(Missouri modifications subtractions)[15]
	$400,946,885	(Missouri taxable income – all sources)
-	***$148,555,163***	***(nonbusiness income – passive interest income)***
	$ 252,391,722	(total apportionable interstate income)
x	0.09608	(wire mileage method percentage)
	$ 24,249,797	(interstate income apportioned to Missouri)
÷	$401,016,705	(total federal taxable income)
	0.06041	(Missouri income percentage)

Second, we calculate the corporate income tax liability:

	$400,946,885	(Missouri taxable income – all sources)
x	0.06041	(Missouri income percentage)
	$ 24,221,201	(Missouri taxable income)
x	0.0625	(Missouri corporate income tax rate)
	$ 1,513,826	(final Missouri corporate income tax liability)

33. By allocating passive interest income outside Missouri, AT&T SW's final corporate income tax liability for the 2003 tax year is $1,513,826. By treating AT&T SW's passive interest income as allocated nonbusiness income, its corporate income tax liability for the 2003 tax year reduced by $86,511 from what it filed on its 2003 tax return.

[15] This amount is the Missouri depreciation basis adjustment that the Director approved.

Director's Final Decision

34. On June 6, 2011, the Director issued his final decision upholding his notices of deficiency for all three tax years: 2003, 2004, and 2005.

Conclusions of Law

We have jurisdiction over appeals from the Director's final decisions.[16] Our duty in a tax case is not to review the Director's decision, but to find the facts and to determine, by the application of existing law to those facts, the taxpayer's lawful tax liability for the period or transaction at issue.[17] Statutes imposing a tax must be strictly construed in favor of the taxpayer.[18] AT&T SW has the burden of proof.[19]

I. Overview

AT&T SW is a corporation that operates telephone lines, as defined by § 143.441, which provides:

> 1. The term "corporation" means every corporation, association, joint stock company and joint stock association organized, authorized or existing under the laws of this state and includes:
>
> * * *
>
> (4) Every corporation, or receiver in charge of the property thereof, which operates a telephone line or lines extending from this state to another state or states or a telegraph line or lines extending from this state to another state or states.

The calculation of corporate income tax in this case stems from the wire mileage method derived from § 143.451, which provides:

> 1. Missouri taxable income of a corporation shall include all income derived from sources within this state.

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[16] Section 621.050.1.

[17] ***J.C. Nichols Co. v. Director of Revenue***, 796 S.W.2d 16, 20-21 (Mo. banc 1990).

[18] Section 136.300.1; *see also* ***American Healthcare Management, Inc. v. Director of Revenue***, 984 S.W.2d 496, 498 (Mo. banc 1999).

[19] Section 621.050.2.

* * *

> 6. A corporation described in subdivision (4) of subsection 1 of section 143.441 shall include in its Missouri taxable income all income arising from all sources within this state. Income shall include revenue from each telephonic or telegraphic service rendered wholly within this state; from each service rendered for which the only facilities of such corporation used are those in this state; and from each service rendered over the facilities of such corporation in this state and in other state or states, such proportion of such revenue as the mileage involved in this state shall bear to the total mileage involved over the lines of said company in all states. The taxpayer may elect to compute the portion of income from all sources within this state in the following manner:
>
> (1) The income from all sources shall be determined as provided;
>
> (2) The amount of investment of such corporation on December thirty-first of each year in this state in telephonic or telegraphic facilities, real estate and improvements thereon, shall be divided by the amount of the total investment of such corporation on December thirty-first of each year in telephonic or telegraphic facilities, real estate and improvements. The income of the taxpayer shall be multiplied by fraction thus obtained to determine the proportion to be used to arrive at the amount of Missouri taxable income.

Essentially, the total investments AT&T SW has in Missouri on December 31 each year is divided by AT&T SW's total investments everywhere on December 31 each year to create the wire mileage percentage. This percentage determines the proportion of AT&T SW's total interstate income that is apportioned to Missouri for state corporate income tax purposes.

The all-encompassing issue in this case, whether it be in the form of modifications or allocation, is whether passive, non-Missouri source interest income may be removed from total interstate income before it is apportioned to Missouri through the wire mileage method. To determine this all-encompassing issue, we divided it into three narrower issues, as outlined above, before our findings of fact. We now examine those three narrower issues.

II. First Issue – Non-Missouri Source Income

AT&T SW argues that the passive interest income received from AT&T is non-Missouri source income because both corporations were formed outside Missouri, both corporations were domiciled outside Missouri, AT&T used or invested the loaned funds outside Missouri, and all decisions regarding the use or investment of loaned funds were made outside Missouri.

The Director argues that the passive interest income received from AT&T is Missouri source income because the loaned funds originated from customer payments in Missouri and AT&T had operations in Missouri.

In determining whether passive interest income under the facts of this case is derived from a Missouri source, we seek guidance from the Supreme Court. The Director cites: ***In re Kansas City Star Co.***,[20] ***Union Electric Co. v. Coale***[21] ("***Union Electric I***"), ***Petition of Union Electric Co. of Missouri***[22] ("***Union Electric II***"), ***A.P. Green Fire Brick Co. v. Mo. State Tax Commission***,[23] and ***Brown Group, Inc. v. Administrative Hearing Commission***.[24] Both parties cite: ***Medicine Shoppe International, Inc. v. Director of Revenue***[25] ("***Medicine Shoppe II***").

In ***In re Kansas City Star Co.***, the taxpayer was a corporation that owned four newspapers and a radio broadcasting station. Its principal place of business was in Missouri, with news bureaus and correspondents in various other states and the District of Columbia. The taxpayer was required to pay state income tax on its net income from sources within Missouri. The taxpayer apportioned to Missouri that proportion of its total income that equaled the percentage of its newspaper circulation in Missouri. The county assessor challenged this method

[20] 142 S.W.2d 1029 (Mo. banc 1940).
[21] 146 S.W.2d 631 (Mo. 1940).
[22] 161 S.W.2d 968 (Mo. banc 1942).
[23] 277 S.W.2d 544 (Mo. 1955).
[24] 649 S.W.2d 874 (Mo. banc 1983).
[25] 156 S.W.3d 333 (Mo. banc 2005).

of apportionment, claiming that all of the taxpayer's income came from Missouri under the theory that all business was conducted by the taxpayer at its principal place of business in Missouri. The Supreme Court held, "…the source of income is the place where it was produced[.]"[26] It went on to state that the income was produced everywhere that the taxpayer conducted business, including its news bureaus, its delivery of newspapers outside Missouri, as well as its business within Missouri.[27] Under the facts before us, the Director argues AT&T SW's passive interest income is Missouri source income because the principal of the loan originated in Missouri. However, ***In re Kansas City Star Co.*** supports that the source of income is outside Missouri because all decisions made regarding the use or investment of the loan funds that produced the passive interest income were made outside Missouri.

In ***Union Electric I***, the taxpayer was a Missouri corporation, located in St. Louis, that supplied electricity and steam to its customers. The taxpayer owned stock in eight foreign corporations and an unincorporated foreign stock company. In 1936, the taxpayer received dividends from these nine companies. The dividends were derived from the capital and operations employed by these companies in their respective states. None of these nine companies employed or had capital in Missouri in 1936, and they did not engage in business or any other operations in Missouri in 1936. The taxpayer reported this dividend income on its 1936 tax return, but did not include it as Missouri taxable income. The assessor of St. Louis and the state auditor argued that the stock held by the taxpayer had a *situs* in Missouri, evidenced by the actual stock certificates being present in Missouri. As such, they alleged Missouri should be the source of the dividend income. The Supreme Court held that "…source is defined as 'the individual, company, or corporation initiating a payment, as of dividends, interest'…"[28]

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[26] ***In re Kansas City Star Co.*** at 1037.
[27] *Id.* at 1039.
[28] ***Union Electric I*** at 635.

Therefore, the Supreme Court held that the source of the dividends came from outside Missouri, where the nine foreign companies initiating the dividends payments conducted business. Similarly, under the facts before us, the source of passive interest payments is AT&T, which is domiciled outside Missouri and is the corporation initiating the payment of interest. Therefore, under ***Union Electric I***, the source of passive interest payments is not the source of the principal of the loan funds, it is AT&T, which initiated payment of the loan funds.

Union Electric II deals with the 1937 and 1938 tax years with similar facts to ***Union Electric I***. The same taxpayer owned stock in eight foreign corporations and an unincorporated foreign stock company. Again, the taxpayer received dividends from each of these nine companies in 1937 and 1938. However, in ***Union Electric II***, one of these foreign corporations was also licensed to do business in Missouri. With the exception of this corporation, all of these companies continued to operate entirely outside Missouri. Another major difference with ***Union Electric I*** is that the taxpayer also owned bonds in an Illinois corporation that conducted business exclusively in Illinois. The Illinois corporation paid interest on its bonds to the taxpayer in 1937 and 1938. The sole issue in ***Union Electric II*** was whether the dividends and interest received by the taxpayer were income received from sources within Missouri. The Supreme Court held there are three sources of income: labor, use of capital, and profits from sale. In the "case of income derived from labor, it is the place where the labor is performed; in the case of income derived from use of capital, it is the place where the capital is employed[.]"[29] The Supreme Court continued, "the actual expenditure of labor and the actual use of capital which gave rise to the income represented by these dividends took place outside the state of Missouri. We are forced to the conclusion therefore that the source of this income was outside the state and the dividends received by the taxpayer should not be included in its gross income for the purpose

[29] ***Union Electric II*** at 970.

of computing its Missouri income tax."[30] The Supreme Court continued, "interest payments must be treated in the same manner as the dividend payments" and found that the source of interest on the bonds was outside Missouri.[31] The fact that one of the foreign corporations operated in Missouri was not a factor the Supreme Court used in determining source of income.

Under the facts before us, the decisions regarding how to use or invest the loan funds -- like the dividends and interest payments in ***Union Electric II*** -- were made outside Missouri. Furthermore, the capital is held and employed outside Missouri. Finally, under the facts of ***Union Electric II***, the fact that AT&T operates in Missouri has no bearing on the facts before us – that passive interest payments were generated outside Missouri. Therefore, under the holding in ***Union Electric II***, the passive interest payments to AT&T SW came from sources outside Missouri.

In ***A.P. Green Fire Brick***, the taxpayer was a Missouri corporation engaged in manufacturing. The taxpayer received royalties from companies organized in foreign countries. These royalties were paid to the taxpayer in return for the use of the taxpayer's trademarks, trade names, and manufacturing processes in areas wholly outside the United States. The sole issue is whether these royalties were income from sources within Missouri. The Supreme Court held, "…the 'source' of the income was the place where the trademarks, trade names and manufacturing processes were used and the income produced."[32] Thus, the source of the royalties was outside Missouri. To the extent these facts are applicable to the facts before us, AT&T used or invested the loan funds outside Missouri and produced the income that generated the passive interest payments outside Missouri. Therefore, the source of the passive interest income paid to AT&T SW, under the holding in ***A.P. Green Fire Brick***, is outside Missouri.

[30] ***Union Electric II*** at 971.
[31] *Id.* at 972.
[32] ***A.P. Green Fire Brick*** at 547.

In ***Brown Group***, the taxpayer was a manufacturer and wholesaler of shoes with its principal place of business in Missouri. The taxpayer received royalties from a Japanese corporation in return for the use of the taxpayer's trade names, shoe designs, and shoe patterns. The Supreme Court agreed with ***A.P. Green Fire Brick*** and held that "'source of income' is the place in which the trademarks, trade names and manufacturing processes are used and the income produced."[33] This case contains the same holding as ***A.P. Green Fire Brick***. Similarly, under this holding, the source of passive interest income paid to AT&T SW is where AT&T used or invested the loan funds, which is outside Missouri for the same reasons we described above under ***A.P. Green Fire Brick***.

In ***Medicine Shoppe II***, the taxpayer was a Delaware corporation with its headquarters in Missouri. All of the taxpayer's offices, officers, and employees were located in Missouri and franchised retail shops throughout the United States. The taxpayer was a wholly owned subsidiary of an Ohio corporation. The taxpayer entered into an investment agreement with its parent corporation whereby:

> any funds in [taxpayer]'s bank accounts at the end of each day in excess of those needed for operating expenses are transferred to a [parent corporation] 'corporate concentration account.' [Parent corporation] invests the funds in this account for [taxpayer]'s benefit. The investible funds remain assets of [taxpayer], but [parent corporation] has control over the funds in the account and the investment decisions. [Parent corporation] pays [taxpayer] interest on the invested funds at a rate of return of 7.72% per annum that is credited to the investable funds account on a monthly basis.[34]

The issue is whether the taxpayer "can exclude so-called 'passive' investment income – earned on non-operating excess funds invested by the corporation's parent company in another state –

[33] ***Brown Group*** at 880.
[34] ***Medicine Shoppe II*** at 336.

before applying the [apportionment] formula for determining what portion of its income Missouri may tax."[35] The Supreme Court held:

> The record does not show how and where [parent corporation] invested the funds it received from [taxpayer] pursuant to the investment agreement. It is undisputed, however, that the funds from Missouri were controlled by the Ohio-based parent corporation and the only decision over which [taxpayer] has any control is whether to terminate the investment agreement. Appropriately applying these principles, the Administrative Hearing Commission determined that the investment income from [parent corporation] is not income from sales or business transacted for Missouri income tax purposes[[36]]

This case contains facts identical to the case before us. Accordingly, just like ***Medicine Shoppe II***, we find that the investment income from AT&T, in the form of passive interest income, is not income from sales or business transacted in Missouri. Therefore, it is from sources outside Missouri.

In conclusion, all of the cases cited by both parties support the fact that the passive interest income received by AT&T SW is non-Missouri source income. Accordingly, we find that the passive interest income is non-Missouri source income because: decisions made regarding the use or investment of the loan funds that produced the passive interest income were made outside Missouri; the loan funds were held outside Missouri; the loan funds were used outside Missouri, thus producing the interest income outside Missouri; and the loan funds were controlled by parent corporation AT&T outside Missouri.

III. Second Issue – Allocation of non-Missouri Source Income

On its 2004 and 2005 tax returns, AT&T SW allocated its passive, non-Missouri source interest income. It did so under the theory that ***Medicine Shoppe II*** is on point with the facts

[35] ***Medicine Shoppe II*** at 335-336.
[36] *Id.* at 338.

before us and that the statute in ***Medicine Shoppe II***, § 143.451.2, should be construed together with the statute before us, § 143.451.6.

The Director disagrees and argues the passive interest income under the facts before us is Missouri source income and that § 143.451.6 does not contain a provision that allows for allocation of passive, non-Missouri source income. We have already addressed the issue of the source of this income above. So we move to the Director's next argument.

Under ***Medicine Shoppe II***, there are two requirements that a taxpayer must meet in order to allocate income outside the state: the income must be passive investment income, and it must be non-Missouri source income.[37] Neither party disputes that the interest payments to AT&T SW are passive investment income. We have already found that the source of this passive interest income is not from Missouri.

Section 143.451.2 is the subject of ***Medicine Shoppe II***. This statute provides the basis for apportionment of income for all corporations other than those engaged in telephone/telegraph service, interstate travel, or the operation of a bridge across state lines. Section 143.451.2 does not contain a provision for allocation of passive, non-Missouri source income. When issuing its opinion in ***Medicine Shoppe II***, the Supreme Court first looked to the general language of § 143.451.1 which requires a corporation to pay tax on all income derived from within Missouri.[38] Using this as the basis, the Supreme Court went on to hold that passive, non-Missouri source income may be allocated under § 143.451.2.[39] Just as the Supreme Court did not feel a provision allowing for allocation of passive, non-Missouri source income is necessary in § 143.451.2, we find there is no need for such a provision in § 143.451.6. In conclusion,

[37] ***Medicine Shoppe II*** at 338.
[38] *Id.* at 337.
[39] *Id.* at 338.

AT&T SW's passive, non-Missouri source interest income for tax years 2004 and 2005 may be allocated as nonbusiness income under § 143.451.6.

However, we have recalculated AT&T SW's corporate income tax liability for both the 2004 and 2005 tax years. Under our calculations its corporate income tax liability for the 2004 tax year increases by $307,204 over what it filed on its 2004 tax return due to the differences in the wire mileage percentage and greater apportioned income used in the Director's final decision and unchallenged by AT&T SW in its complaint. Similarly, its corporate income tax liability for the 2005 tax year increases by $210,258 over what it filed on its 2005 tax return due to the differences in federal income tax and greater apportioned income used in the Director's final decision and unchallenged by AT&T SW in its complaint.

IV. Third Issue – Modifications Subtractions

Section 143.431 provides:

> 1. The ***Missouri taxable income of a corporation taxable under sections 143.011 to 143.996 shall be so much of its federal taxable income for the taxable year, with the modifications specified in subsections 2 and 3 of this section, as is derived from sources within Missouri as provided in section 143.451***. The tax of a corporation shall be computed on its Missouri taxable income at the rates provided in section 143.071.
>
> 2. There shall be added to or subtracted from federal taxable income, ***the modifications to adjusted gross income provided in section 143.121 and the applicable modifications to itemized deductions provided in section 143.141***. There shall be subtracted the federal income tax deduction provided in section 143.171. There shall be subtracted, to the extent included in federal taxable income, corporate dividends from sources within Missouri.

(Emphasis added). While § 143.141 deals exclusively with individual taxpayers rather than corporations, § 143.121 provides:

> 1. The Missouri adjusted gross income of a resident individual shall be his federal adjusted gross income subject to the modifications in this section.

* * *

3. There shall be subtracted from his federal adjusted gross income the following amounts to the extent included in federal adjusted gross income:

(a) Interest or dividends on obligations of the United States and its territories and possessions or of any authority, commission or instrumentality of the United States to the extent exempt from Missouri income taxes under the laws of the United States. The amount subtracted under this paragraph shall be reduced by any interest on indebtedness incurred to carry the described obligations or securities and by any expenses incurred in the production of interest or dividend income described in this paragraph. The reduction in the previous sentence shall only apply to the extent that such expenses including amortizable bond premiums are deducted in determining his federal adjusted gross income or included in his Missouri itemized deduction. The reduction shall only be made if the expenses total at least five hundred dollars;

(b) The portion of any gain, from the sale or other disposition of property having a higher adjusted basis to the taxpayer for Missouri income tax purposes than for federal income tax purposes on December 31, 1972, that does not exceed such difference in basis. If a gain is considered a long-term capital gain for federal income tax purposes, the modification shall be limited to one-half of such portion of the gain;

(c) The amount necessary to prevent the taxation under sections 143.011 to 143.996 of any annuity or other amount of income or gain which was properly included in income or gain and was taxed under the laws of Missouri for a taxable year prior to January 1, 1973, to the taxpayer, or to a decedent by reason of whose death the taxpayer acquired the right to receive the income or gain, or to a trust or estate from which the taxpayer received the income or gain;

(d) Accumulation distributions received by a taxpayer as a beneficiary of a trust to the extent that the same are included in federal adjusted gross income;

(e) The amount of any state income tax refund for a prior year which was included in the federal adjusted gross income;

(f) The portion of capital gain specified in subsection 3 of section 144.747, RSMo, that would otherwise be included in federal adjusted gross income.

> 4. There shall be added to or subtracted from his federal adjusted gross income the taxpayer's share of the Missouri fiduciary adjustment provided in section 143.351.
>
> 5. There shall be added to or subtracted from his federal adjusted gross income the modifications provided in section 143.411.

Section § 143.411, referred to in § 143.121.5, deals with partnerships and is inapplicable to the facts before us. Furthermore, no other provision of § 143.121 provides for a modification subtraction of passive, non-Missouri source interest income. While this income could have been appropriately allocated on AT&T SW's 2003 tax return, it cannot be subtracted as a modification.

However, as we previously stated, our duty in a tax case is not to review the Director's decision, but to find the facts and to determine, by the application of existing law to those facts, the taxpayer's lawful tax liability for the period or transaction at issue.[40] AT&T SW should have allocated its passive, non-Missouri source interest income for the 2003 tax year. Because it failed to do so, we have applied the law to the facts and made that calculation ourselves. This calculation results in a reduction of AT&T SW's corporate income tax liability by $86,511 under what it filed on its 2003 tax return.

V. Interest

Section 143.731 imposes an interest on underpayments in corporate income tax, as calculated by § 32.065. Therefore, AT&T SW shall be liable for this statutory interest on its underpayments for the 2004 and 2005 tax years.

Section 143.811 imposes an interest on overpayments of corporate income tax. Therefore, AT&T SW shall receive this statutory interest on its overpayment for the 2003 tax year.

[40] ***J.C. Nichols Co. v. Director of Revenue***, 796 S.W.2d 16, 20-21 (Mo. banc 1990).

Summary

AT&T SW is entitled to a refund of $86,511 in corporate income tax plus statutory interest for the 2003 tax year. AT&T SW is liable for an additional $307,204 in corporate income tax plus statutory interest for the 2004 tax year; and it is liable for an additional $210,258 in corporate income tax plus statutory interest for the 2005 tax year.

SO ORDERED on June 10, 2013.

*\s\Sreenivasa Rao Dandamudi*________________
SREENIVASA RAO DANDAMUDI
Commissioner